Christian Noyer: Banking in the euro area

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the 30th Anniversary of the Association of Foreign Banks' Representatives, Frankfurt, 8 November 2001.

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I am very grateful for the invitation to speak to you on the occasion of the 30th anniversary of the Association of "Foreign Banks' Representatives in Germany". Your Association has 117 members from a large number of countries. Several of the member institutions are counted among the 30 major European banks, or among banks from elsewhere with important operations in Europe.

For many banks represented by your Association, the topic of my speech *"banking in the euro area"* is part of day-to-day business. It is also day-to-day business for the European Central Bank (ECB) and the Eurosystem as a whole, as we conduct our monetary policy operations and run the TARGET large-value payment system.

The further integration of the European banking system and financial markets is in the interests of both banks and the central bank. For banks, it means the liquidity benefits of deeper and wider markets and lower costs when operating in several countries. From the central bank perspective, it enhances the efficient and consistent implementation of the single monetary policy.

We already enjoy the benefits of a common euro area banking system in important respects. An integrated money market exists for liquidity transfers in euro; banks are inter-connected in a common payment system infrastructure; and wholesale securities market activities and corporate finance services do not recognise geographical borders. However, at the retail level, international banks must still treat each country as an individual market. This is because of localised demand and country-specific banking products, and differences in conduct-of-business and consumer protection rules. The remaining differences in regulatory and supervisory practices can also play a role. I believe that few institutions understand this as well as you do, as you still have to cope with the task of navigating business through various national environments.

I should like to explore this double feature of euro area banking today. On one hand, there is the challenge for central banks and supervisory authorities to respond to the emergence of a common wholesale banking system in order to maintain financial stability. On the other hand, greater integration, also in the retail field, remains an important policy objective. I should like to address the two aspects in turn, starting with wholesale banking and then moving on to the retail side.

A common wholesale banking system

I share the view that a common currency and a common central bank actually determine a unified banking system. In a nutshell, access to a common source of central bank liquidity and a common money market – as well as confidence in the common currency – create strong interconnections between all banks operating in the single currency area. This is the case irrespective of whether we have pan-European banks, or whether discrepancies remain in local retail markets. The case of the United States is illustrative. Even when strong inter-state banking limitations were in place – restricting retail banking activities to small local markets – the US banking system was, nevertheless, commonly viewed as a single system.

Illustrative facts

The progress made with integration in wholesale activities has been rapid and remarkable. First, a *common euro money market* has been in place since the early days of the euro. A large number of financial products can be traded easily with minimal price distortions, small enough to prevent arbitrage across countries. Likewise, data on cross-border trade flows provide a strong indication of market unification. In the case of the predominantly used unsecured interbank contracts, the share of counterparties from other euro area countries has more than doubled after the introduction of the euro. In addition, a large proportion of the activity in euro is conducted with counterparties outside the euro area, especially in London. The share of cross-border transactions is somewhat lower in the case of repo transactions, because of remaining legal and tax barriers and settlement difficulties. All in all, less

than 40% of all interbank market activity is now conducted with domestic counterparties. In 1998, the share was still over 60%.

Second, the *wholesale payment infrastructure* for the euro area – including TARGET, Euro I and Euro Access Frankfurt – is already very unified. Payment flows in these systems again indicate a significant increase in cross-border interbank trading after the introduction of the euro. In terms of value, cross-border transactions currently account for 40% of all kinds of TARGET payments, for instance. The degree of integration is certainly lower for securities settlement, even though a process of consolidation has been taking place.

Third, the degree of integration of *securities market activities* is usually misjudged, since attention is focused on the costs and difficulties of individual investors when investing abroad. The picture is completely different for wholesale activities. The corporate finance markets for major customers are actually already quite highly integrated. To give an example, the share of domestic book-runners for bonds issued by euro area companies dropped from over 80% in 1995 to 36% in 2000. As in many other securities and derivative market activities, the market structure relies on large European or global financial groups. The same trend towards a high level of integration also holds true of wholesale asset management, with investments being increasingly diversified across borders.

In terms of volume, growth has been very impressive in the euro-denominated securities markets, until the very recent slowdown and increased market uncertainty after the tragic events in the United States. The deepening of the markets has been particularly strong for bonds – euro-denominated bonds issued by private entities doubled during 1999, and market activity remained quite strong until the summer of this year.

Challenges stemming from integration

Two major challenges for authorities in charge of financial stability emerge from the common wholesale banking system: vulnerability to common shocks and potential contagion of major problems across many countries, should such problems arise.

Let me take the issue of *common shocks* first. Clearly, integration opens up a wide range of opportunities for growth and contributes to increasing the resilience of the system. It brings along a wider range of funding sources and – on the asset side – the degree of diversification of exposures increases. But integration also renders financial institutions more exposed to common shocks. For the largest banks, area-wide risks affecting specific lines of business increasingly matter more than the home country-related risks.

One way of illustrating this point is to take a look at banks' share price development. Since the beginning of the year, the share prices of almost all major European banks have declined. The 30 largest banks have lost, on average, around 25% of their value. The overall deterioration in global macroeconomic conditions and financial market volumes has affected all institutions, as banks' profit outlook has deteriorated following the likely increase in provisioning needs and reductions in income from market-related activities.

However, the stock market changes for these 30 banks range widely from a small plus to very significant minuses of over 50%. In line with the notion that the home-country risks have lost in importance, banks' nationality is no longer a very relevant determinant of the size of the stock market reaction. To give you just one example, large retail-oriented banks have suffered only a mild deterioration, while the share prices of wholesale and market-oriented banks from even the same countries have declined quite substantially. In general, the greatest stock market reductions have occurred for banks with substantial dependence on declining investment banking activity, or with significant credit exposure concentrations on certain industries – such as the technology sectors or airlines – or troubled emerging markets. These represent common risk elements for euro area banks.

Let me turn to the second issue of the *spreading of problems*. The common wholesale market is clearly a driving force behind efficiency and further integration. Market participants have generally expressed that they are satisfied with the way the market works. Banks are able to borrow liquidity from one another across borders, instead of having to resort to central bank funding. The common money market can also absorb larger disturbances than before. However, banks operating in the common wholesale system form a network, which could facilitate a rapid propagation of shocks across the euro area. A major problem at a key financial institution is likely immediately to be transmitted to other countries, through large and well-capitalised counterparties, or via the effects on liquidity and prices in securities markets.

Responses by central banks and banking supervisors

While responsibility for financial stability remains vested in the national authorities – even in the countries participating in Stage Three of Economic and Monetary Union (EMU) – the need for co-operation among national authorities has increased because of the concerns I have just mentioned. In fact, EU authorities have shown awareness that close co-operation is essential both for a strategy of risk reduction and for the prompt and effective management of any problematic events. Let me refer to some of the main issues pertaining to the activities of central banks and banking supervisors.

First, as to the *Eurosystem responsibilities*, the operational tools established for the common monetary policy allow market-wide liquidity shocks to be dealt with. The quick and successful reaction to the consequences of the terror attacks in the United States was a sign that the institutional framework is able to address the consequences of common shocks.

Already in the evening of 11 September, the ECB announced that it was ready to provide additional liquidity. Indeed, the euro money markets showed some signs of tension on 12 September, because of banks' caution about lending funds due to uncertainty regarding their own liquidity needs. The ECB ensured the availability of adequate liquidity through a quick tender operation, restoring a normal functioning of the market, in the same way as, for instance, the Federal Reserve accomplished this for the dollar money market. In addition, the ECB and the Federal Reserve Bank of New York negotiated a US dollar/euro swap agreement on 12 September. The purpose of the agreement was to channel US dollar funds to European banks, which are not counterparties of the Federal Reserve for its discount window operations. European banks faced difficulties in raising short-term US dollar funds due to the disruption in the US financial system.

Second, as to the *co-operation between central banks and banking supervisors*, the ECB, the national central banks and the banking supervisory authorities of all EU countries have recently signed a Memorandum of Understanding. It establishes arrangements for co-operation and sharing information with respect to risks in large-value payment systems.

Third, as regards *banking supervisors*, the EU Economic and Financial Committee has recently reached the conclusion – also endorsed by the finance ministers – that, while the existing institutional arrangements for supervision and crisis management are adequate, cross-border co-operation needs to be fostered. The co-operative bodies of banking supervisors in the European Union – the Banking Supervision Committee of the ESCB and the Groupe de Contact – are currently addressing this recommendation.

The opinion of the ECB is also that the existing arrangements can provide an adequate and flexible basis for safeguarding financial stability at the *European level*. We have also stressed that co-operation needs to be enhanced in order to ensure the effective execution of prudential supervision and corrective action in crises. For the single monetary policy, it is important that financial stability is effectively maintained.

Let me make some remarks also about the supervisory arrangements at the *national-level*. After the reform carried out in the United Kingdom to establish a single all-encompassing financial supervisory authority outside the central bank, proposals to set up a single supervisory authority have been put forward in several euro area countries. Tendencies to separate supervision from central banking have also emerged. In almost all euro area countries, central banks have traditionally been in charge of supervisory functions.

In some euro area countries, adjustments have already been made. In Austria, an all-encompassing financial supervisory authority will be established, but the central bank will still be in charge of certain banking supervisory tasks. In Luxembourg, a supervisory authority has been created outside the central bank. Changes are also underway or being discussed in Germany, Belgium, Ireland, and Finland.

The Eurosystem has recently expressed the view that continuing to have national central banks in charge of supervisory responsibilities would offer clear benefits. This would be an appropriate response to the challenges triggered by the euro, as it would enhance the capability to monitor risks to financial stability from an area-wide perspective. In any alternative arrangement, the involvement of central banks in prudential supervision and ample information sharing would be necessary in order to achieve the necessary interaction between the two bodies.

A central bank supervisor is in a position quickly to assess systemic risks. These could be generated, for example, by a failure of a large and complex financial institution through payment and settlement

systems and securities markets. We have also considered that the traditionally expressed arguments in favour of separating prudential supervision and central banking would not be very convincing in the specific euro area conditions. For instance, the concern of conflicts of interest with monetary policy and a lack of domestic accountability should not be overstated in our setting where monetary policy is centralised and supervision remains national.

Still dispersed retail markets

Despite the progress I have mentioned, the markets for retail financial services are still defined quite strongly along national, or even local, lines. In these markets, for instance, interest rates are based on local competitive conditions, as you know very well. However, this does not mean that there is no *international competition*. The fact that this Association has now existed for thirty years is a clear sign that financial institutions have already been international for a long time.

Internationalisation of retail operations

Until now, branches and subsidiaries abroad have been preferred to large-scale mergers as a strategy for entering foreign banking markets. The establishment of foreign branches and subsidiaries has increased steadily in the euro area. For example, the number of foreign branches of German banks in the European Union is now 59, almost double that of 1995. The average market share of foreign branches and subsidiaries established by banks from EU countries was 10% at the end of 2000, which is definitely not negligible.

Also, the ownership structure of the banking sector is changing significantly. It is no longer true that only Luxembourg's banks have a significant proportion of capital owned by foreigners. In Ireland, Belgium and Portugal, and in the Nordic countries, the percentage of banks' capital in foreign hands ranges from around 40% to some 20%. France, Italy, Spain and Austria also show ratios of between 15% and 10%. For many large European banks, the holdings of stakes in other large players is sometimes associated with joint ventures in specific business lines or geographic areas – for example, in accession countries.

Looking at the strategies of individual banks, some banks have already developed strong multi-country operations in the retail field. For instance, two major banking groups have retail activities in more than five EU countries. In any case, if the integration of the retail markets proceeds, more such operations could be expected to emerge. Integration could also be advanced via electronic banking, or cross-border lending, both of which are still relatively limited. In fact, e-banking could represent a forceful boost to integration, since it could allow customers to access banking services offered by banks in other countries, or it could be a powerful way to enter a new market without the need to establish a costly branch network.

Responses by European authorities

As noted, banks with international operations have to develop local products, also to comply with different legal systems, which implies significant costs. Important steps are being taken by EU authorities to overcome the obstacles of segmentation. However, legal aspects are only one element hindering the integration of the retail markets, since proximity to the customer is still an important factor. Even though it is likely that the retail markets will maintain local features at least for some time to come, any unnecessary burden on the cross-border expansion of activities should be lifted to the maximum extent possible.

At the *regulatory level*, the European Commission is generally striving to finalise the Single Market programme via the so-called Financial Services Action Plan. The higher cost of cross-border retail payments, as compared with domestic ones, has been a very topical issue, and it has been taken as a sign of a lack of integration. In July 2001, the European Commission proposed a draft Regulation to close the gap between domestic and cross-border payments. In the draft now being examined by the Council and the Parliament, banks would be obliged to equalise prices for cross-border and domestic payments. The ECB has stated that the Eurosystem shares the general objective of the Regulation. However, the Eurosystem has expressed reservations about the chosen method, because it gives too little time to the banking industry to adjust in a rational way. In this context, I find the recent initiative of the European Banking Federation for a self-imposed calendar for reducing the level of such fees extremely promising.

Steps are also being taken in the field of consumer protection legislation. The aim of the recently launched revision of the Consumer Credit Directive is to promote transparency and to ensure that cross-border credit can flow in harmonised conditions for both consumers and lenders. Also, a report on the regulation of e-commerce in financial services has just been launched by the Commission. It draws attention to the problems that arise from the interplay between different legal systems and makes proposals to overcome them.

At the supervisory level, the Economic and Financial Committee has stressed the need to work on the convergence of diverging national supervisory practices. The main motivation is to enhance the efficiency of the national supervisory authorities involved in monitoring cross-border financial institutions and thereby to improve financial stability. This is also linked to the new framework for capital adequacy rules being developed by the Basel Committee on Banking Supervision that will significantly increase the scope for supervisory discretion, leaving broad room for diverging implementation across Member States. Thus, demand for supervisory convergence is going to increase. To the extent that this is accomplished, the costs of banks with multi-country operations will also become lower.

Conclusion

In conclusion, I should like to stress that when talking about the requirements of the euro area banking system, we are not concerned with ordinary co-operation across Member States, as is necessary on account of the internationalisation of financial firms' activities. We talk about a single banking sector. This means that only substantially reinforced co-operation, combined with convergence in supervisory policies and practices, can deliver the conditions for a continued integration of banking activities. This will mitigate the potential risks to financial stability that stem from the new channels of contagion and will, in turn, benefit euro area economic activity.